27 October 2023

Via email IM.Review@comcom.govt.nz

Tēnā koe,

Cross-Submission on further consultation relating to the draft decision on the cost of debt wash-up for EDBs and GTBs

Powerco welcomes the opportunity to provide a cross-submission on the Commerce Commission's further consultation relating to the draft decision on the cost of debt wash-up for EDBs and GTBs.

Our cross-submission comments on issues including:

- Concerns that the proposed debt wash-up is worse than the status quo
- Whether the Commission's assumptions reflect EDB debt management
- Materially better solutions proposed by Competition Economists Group (CEG)

This cross-submission does not contain any confidential information and can be published to the Commission's website unaltered.

If you have any questions regarding this submission or would like to talk further on the points we have raised, please contact Jeremy Smith [redacted]

Nāku noa, nā,

[redacted]

Jeremy Smith
Regulatory Manager
POWERCO

Comments on submissions

Is the mechanism better than the status quo?

Powerco's view of the proposed mechanism is that we support the intention of the mechanism, however as other submitters have commented, it does not address the debt compensation issue or address the underlying cause of the 'error'. We believe that unless a proposed mechanism proactively addresses the underlying issue, it should not be implemented, anything else would be a significant step backwards to the status quo, where EDBs are compensated for 100% of the debt portion of RAB in line with actual inflation.

The Commission's current preferred mechanism allows the RAB to be revalued by actual inflation, which is likely to be higher or lower than forecast inflation, and then reactively corrects for any forecast error by adjusting revenue allowances in the current regulatory period. This exposes EDB's to more uncertainty and volatility, compared to an adjustment in RAB revaluation process which would remove the potential for error on the debt portion of the RAB, without impacting revenue and cashflows in the current regulatory period.

The ENA submission[1] supports the notion that the underlying issue is not addressed with the proposed mechanism.

- "*Proposed smoothing of the accumulation of the debt washup address…price volatility…it does not address the underlying volatility of the nominal debt differential.*"

Vector's submission[2] shares concerns that the mechanism does not improve on the existing exposure to actual inflation, a concern we share.

- "*extremely concerned that the proposed debt wash-up mechanism is materially worse than the status quo and we urge the Commission to implement the materially better alternative proposed by CEG's report, the amended Blended CPI model.*"

CEG's report[3] for the 'Big 6' EDBs outlines inconsistency in the mechanism and points out that it will exacerbate the challenges of debt and capital management.

- "*In summary:*

  a. *The rationale for assuming EDBs debt costs are fixed in nominal terms is that they can accurately forecast their likely debt raising requirements and lock-in interest rates prevailing immediately prior to the DPP;*
  b. *Seeking to target a fixed nominal compensation for debt prevailing at the beginning of the DPP by adjusting DPP revenues in the face of unexpected inflation is internally inconsistent with the rationale for doing so.*

  If the regulatory debt compensation is to target fixed nominal debt costs then, in my view, it behoves the Commerce Commission to design the regime in which the quantum of borrowing is

[1] https://comcom.govt.nz/__data/assets/pdf_file/0022/331834/Electricity-Networks-Aotearoa-Submission-on-specific-matters-for-the-IM-Review-2023-Cost-of-debt-17-October-2023.pdf

[2] https://comcom.govt.nz/__data/assets/pdf_file/0026/331838/Vector-Submission-on-specific-matters-for-the-IM-Review-2023-Cost-of-debt-17-October-2023.pdf

[3] https://comcom.govt.nz/__data/assets/pdf_file/0019/331840/27Big-627-EDBs-CEG_-Targetting-a-nominal-cost-of-debt-Submission-on-specific-matters-for-the-IM-Review-2023-Cost-of-debt-17-October-2023.pdf

predictable at the beginning of the DPP. That is, the Commission should eschew revenue adjustments in favour of revaluation adjustments."

- "*Circa 98% of the reason the current regime does not deliver compensation for a fixed nominal cost of debt is due to revaluation of the debt RAB using actual inflation. It is peculiar that the Commission's preferred "solution" is to leave the source of the problem (RAB indexation) unchanged and, to attempt to offset this via a revenue adjustment."*

- "*There would also be significant economic costs and dislocation to EDBs capital management activities, cash-flows, and "financeability" if a revenue wash-up were pursued. These costs would not exist if the adjustment was solely to RAB indexation."*

How do EDB's manage debt?

EDBs have debt portfolios that vary in both tenor and rate structure, with debt raising occurring throughout regulatory periods as debt matures. The Commission's assumption that EDBs fix all their debt costs at the beginning of a regulatory period in the reference period does not reflect reality.

Information Disclosure Schedule 5c Report of Term Credit Spread Differential Allowance highlights that EDBs including Powerco, have debt with a tenor longer than 5 years. This debt is not aligned with the term of the regulatory period and some will come up for renewal or refinancing during a regulatory period. While compensation is provided for the longer debt term, the assumption is that this debt would have been fixed at the nominal fixed cost of debt at the start of the regulatory period, when in reality it will be refinanced at market rates when the term ends. Therefore, it would not be possible to hedge to the determined fixed debt nominal rate.

Chorus' submission[4] shares our view that firms cannot hedge for all variances from the nominal fixed cost of debt specified in each DPP reset, noting that the Commission has previously noted the efficiency of staggered debt maturity.

- "*the Commission's assumption that all firms can, or should, hedge their entire debt portfolio to fixed rate nominal terms for the duration of a regulatory period is not plausible. That is to say, in some cases there is already an inconsistency between the cost of debt assumption in the cost of capital and how regulated firms actually finance their businesses."*

- "*The Commission has acknowledged previously that staggering debt maturity dates is an efficient financing practice, resulting in the observed cost of debt for firms varying across each year*[5]"

- "*For firms that are able to hedge to fixed rates, but are currently exposed to floating rate debt, or to fixed term debt with staggered maturities, there could be significant costs incurred in altering the characteristics of their debt portfolio to match that assumed by the Commission at the commencement of next regulatory period."*

We agree with CEG's comments on the limitations of hedging to match the nominal fixed cost of debt.

---

[4] https://comcom.govt.nz/__data/assets/pdf_file/0023/331835/Chorus-Submission-on-specific-matters-for-the-IM-Review-2023-Cost-of-debt-17-October-2023.pdf

[5] Commerce Commission, Cost of Capital Topic Paper Part 4 IM Review 2023 - Draft Decision, 14 June 2023 [at paragraph 3.26].

- "*It is impossible for an EDB to fix 100% of its debt funding over the DPP in the presence of unexpected inflation that feeds into RAB indexation. This is because funding costs for variations from the expected RAB cannot be hedged with interest rate swaps.*"

A better solution proposed

Powerco supports a solution that addresses the underlying issues relating to the debt-funded portion of the RAB. In its report CEG has outlined a modified Blended CPI method that addresses these issues in a way that is NPV = 0. If a mechanism is to be implemented in this IM Review, we support the method outlined in the GEG report, otherwise, the Commission should not make any changes to the current regime and perhaps include for review with more comprehensive analysis and consultation in the next IM review.

We support the proposal by Chorus in its submission to allow firms to 'opt-in' to a debt wash-up mechanism, given how circumstances and debt structure vary by firm.

- "*we recommend allowing firms, or the Commission, to select whether to apply the debt cost wash-up for the upcoming regulatory period, based on the circumstances of the firms. Such a change would better promote the purpose of Part 4, including incentives to invest.*"

We agree with statements in CEG's report that the "Blended CPI" method is superior to all other methods proposed and support the adoption of the modified "Blended CPI" approach they have proposed.

- "*The Commission's "Blended CPI" method is far superior to a revenue wash-up. This method can be amended in line with the discussion in Section 6 to allow for more realistic modelling of what debt costs can reasonably be assumed to be fixed at the beginning of the DPP. If the Commission is not able at this stage of the consultation to adopt more realistic assumptions about how much debt it is possible/efficient to fix during the cost of debt averaging period then the Commission should reconsider making any changes to the current regime*."

- "*The Commission states that it prefers a revenue wash-up over a "Blended CPI" (or similar) solution on the grounds that the former is simpler to implement within existing regulatory/spreadsheet models. I do not agree that this is the case. However, even if it were the case, the additional complexity of spreadsheet models is trivial when compared to the cost of additional complexity in EDBs' capital management if a revenue wash-up is implemented.*"